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AGENDA ITEM 9a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Global Equity Program Restructuring

II. PROGRAM: Global Equity

III. RECOMMENDATION: Information

IV. ANALYSIS:

Background

Beginning with the August 13, 2007 Investment Committee meeting, Global Equity staff has presented an agenda item in Open Session (Attachment 1) that outlined a number of potential enhancements to improve and update the structure of Global Equity. The primary motivation for these changes is the objective of increasing the above benchmark or "active" return of the asset class. The most significant of these changes are:

- Increase the capital allocated to the Corporate Governance and Risk Managed Absolute Return (RMARS) programs
- Extend the RMARS decision making process to other portions of Global Equity where appropriate
- Adopt a market capitalization weighted global benchmark

This agenda item is intended to provide an update to the Investment Committee on the status of these changes and to identify several items where the staff requests feedback and input from the Committee. An Opinion letter from Wilshire Associates is included (Attachment 5).

Corporate Governance and Risk Managed Absolute Return Programs

As indicated in the October 15, 2007 Global Equity Program Restructuring agenda Item (Attachment 2), both the Corporate Governance and Risk Managed Absolute Return (RMARS) programs have demonstrated an ability to outperform their respective benchmarks over longer periods. The contribution from these programs has warranted an increase in the allocation of assets to them. The Investment Committee approved increased allocations to these programs in June of 2007 (Attachment 3). Since the October agenda item, staff has allocated an additional $890 million to the RMARS program and $660 million to Corporate Governance.

Risk Managed Absolute Return Decision Model

Global Equity staff is also working on extending the RMARS decision making model for use in the external manager program and Global Equity in general. This decision making model modifies the due diligence, portfolio construction and contracting process to create a more efficient capital allocation structure focused on the creation of a portfolio with the most attractive risk and return characteristics possible. The overriding objective is to make all capital allocation decisions in a total Global Equity portfolio context. Prior to current asset levels, many of the various programs in Global Equity were small enough that the impact on the overall portfolio was minimal. In these instances, decision making was based on a specific portfolio's characteristics and performance versus the applicable benchmark.

Global Equity Benchmark Change

The Investment Committee approved the migration to a global, capitalization weighted benchmark structure in December 2007. Global Equity staff has been working to create an implementation plan for this transition that also recognizes the effect of the Investment Office's adoption of the new overall PERF asset allocation. To date, the following have been done:

- Creation of a model to extract current market values of all individual Global Equity strategies into a tool that reflects the values as allocations to the various segments of the global equity markets.

- Global Equity has continued to be a source of liquidity to the overall fund. This posture was adopted in the fall of 2007 in recognition of the somewhat unattractive overall equity investment environment and the potential for capital shifts resulting from the Plan's asset allocation work. Global Equity exposure (excluding AIM) constitutes about 53% of the total plan as of January 23, 2008. The new asset allocation target for Global Equity adopted by the Board in December 2007 is 56% (reduced from

60%). The reduction in equity exposure has taken place in the domestic market segment and thus has moved Global Equity in the direction of the benchmark shift.

Additional Considerations

There are several topics where more work needs to be done before beginning the transition. The primary items are reflected below:

- Confirm the benchmark adjustments to the outside data providers (Wilshire Associates and FTSE) and initiate the flow of the modified data into CalPERS' portfolio management tools.

- Review, with Wilshire Associates, their role in the benchmark normalization process and initiate the data movement attached to the normalization.

- Review the transition plan with Wilshire Associates and agree on the methodology to measure the expense of the activity and also the progression of the benchmark weight adjustments.

Examination of the upcoming activity has identified two market segments where staff request feedback from the Investment Committee. The first segment is the small and micro-cap portion of the developed international markets. The second segment is emerging markets. In both, staff has identified the desirability of establishing internally managed index portfolios to increase the flexibility of the transition activity and to provide a completion of the internally managed investment opportunity set. A related consideration is the migration to "mainstream" status of the two emerging market strategies currently resident in the Developmental Fund. The following topics need to be addressed in consideration of these ideas:

Rationale for expanding internally managed portfolios – The Global Equity internal equity management team is successfully managing a broad array of index and enhanced/active strategies. Included in this group are:

Domestic Portfolios

- Wilshire 2500 - Index
- Wilshire 5000 Micro-cap Completion - Index
- Affiliate and Pooled S&P 500 - Index
- PREES Extended Market (Real Estate) - Index
- Russell 2500 - Index
- Dynamic Completion – Index
- Enhanced Index – Enhanced / active

- Fundamental – Enhanced / active

International Portfolios

- FTSE All World Developed Markets (ex U.S.) – Index
- International FTSE EPRA / NAREIT (Real Estate) - Index
- Fundamental Developed Markets – Enhanced / active
- Structured Emerging Markets (Developmental) – Enhanced / active
- Fundamental Emerging Markets (Developmental) – Enhanced / active

This roster of internally managed portfolios represents about $83 billion in assets and has grown as staff has developed the tools, personnel, data feeds, policies and organizational structure to support it.

The fundamental reasons underlying internal management are capitalizing on the relatively low cost structure of internal management and benefiting from the staff's ability to generate value added long term performance in a number of portfolios. The capability of the internal team also provides the maximum degree of flexibility for asset allocation purposes and facilitates management of all transition activity. Extending the internally managed opportunity set to international small / micro-cap and emerging markets index portfolios would serve to provide CalPERS with a complete global equity index management capability. In addition, these portfolios would provide a liquidity source within two market segments where capital flows can be disruptive and where external manager capacity is constrained.

Implementation – An array of portfolio management tools are utilized within the internal team. These tools, while under continual evolution and development, have proved capable of managing any type of index portfolio. Existing staff has the experience and ability to add two new portfolios. It needs to be recognized that additional portfolios, when combined with the activity of implementing the transition, is likely to utilize all available capacity within the internal equity team. CalPERS' back office staff has gained tremendous experience and capability through the activity attached to the two developmental emerging strategies. The back office team has indicated that the work flowing from two new portfolios could be absorbed with the present resources.

A consideration in the emerging market segment is determining a process by which staff can incorporate the CalPERS' Emerging Equity Market Principles. Staff has identified an outside vendor capable of applying a "Principles" relevant screen to the emerging universe. The current developmental emerging portfolios have continued to adhere to the historic "Permissible Markets" country list pending identification of a viable replacement process. Assuming adoption of the "Principles" screen, the two developmental emerging portfolios could be elevated to "mainstream" status and be available for capital allocations. The management of these portfolios has been well integrated within the team since their inception in June 2007. The performance of these portfolios through December 2007 is:

Absolute and (Relative) Performance of
Current Internally Managed Emerging Markets Portfolios

	Inception (6/1/07)	FYTD
Fundamental Emerging	+19.42% (+0.75%)	+15.58% (+0.38%)
Structured Emerging	+18.50% (-0.17%)	+15.63% (+0.43%)
External Emerging Managers	NA	+12.96% (-1.91%)

These performance numbers reflect a short time period and should not lead to any conclusion beyond being encouraged by the results of the internal programs. Performance in emerging markets can be extremely volatile. Assuming the continued success of these strategies, staff will propose to the Investment Committee that these strategies be elevated in status after the strategies' one year anniversary.

Pros / Cons – Here is a listing of the positive and negative implications of adding an international small / micro-cap index portfolio, adding an emerging markets index portfolio and elevating the existing emerging portfolios:

Pro

- Cost saving – Average external manager fees paid in these market segments could range from 25 to 40 basis points. This implies an external management cost of anywhere from $2.5 to $4.0 million for each $1 billion in capital managed. Internal management saves this expense although does not address any performance differences.
- Staff experience – Expanding the types of assets being managed internally provides a greater depth of experience and also facilitates the development of perspectives that lead to active or value added processes.
- Aids further development of the tools and processes used to manage equity assets as the array of issues and data requirements becomes more demanding.
- Increase staff control of the transition to the new Global Equity benchmark.
- Avoid the need to seek outside managers and the attendant search and contracting time and expense.

Cons

- Expense of using an external source to perform a screen based on the CalPERS' Emerging Equity Market Principles. This expense is estimated at $250,000.
- Increases the complexity of the internal program.
- Increases the organization's dependence on staff.

Subject to Investment Committee feedback, staff plans to return with a March 2008 Action Item related to the two new index strategies.

V. STRATEGIC PLAN:

The Global Equity Strategic Plan will further the following goals of CalPERS Strategic Plan:

Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits, and second, to minimize and stabilize contributions.

VI. RESULTS/COSTS:

There are significant costs associated with changes being undertaken within Global Equity. These costs have been outlined in prior agenda items including Agenda Item 7b from the October 15, 2007 Investment Committee meeting (Attachment 4). An additional expense is the anticipated cost of implementing a screen to incorporate the CalPERS' Emerging Equity Market Principles. The Investment Committee shall be periodically updated on these expenses.

As the Global Equity team endeavor to improve the value added contribution from the entire program, additional resources in terms of people, systems, quantitative modeling and support shall be required. Staff will update the Investment Committee on the status of the Global Equity restructure on a quarterly schedule.

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